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THE ACCRUAL OF GROSS INCOME

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A Research Report Submitted to the Faculty of Commerce, University of the Witwatersrand, for the Research Module of the Degree of Master of Commerce by Coursework

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THE ACCRUAL OF GROSS INCOME

BACKWELL, Peter William John

The manner in which income is accrued for the purpose of determining taxable income is the subject of an on-going controversy. This research report is aimed at highlighting the problems attached to the recognition of income for tax purposes.

Various attempts at taking a snapshot of an entity in the midst of its earnings cycle have been made. An examination of the evolution of those attempts has been undertaken with particular focus on the techniques adopted in the recognition of income for the purposes of determining the liability for income tax.

The report incorporates an examination of the basic concepts relating to the recognition of income, the method of income accrual followed in certain foreign tax jurisdictions, and the current state of the law in South Africa. The recommendations formulated by the Margo Commission are analysed, and the shortfalls and anomalies in the various interpretations of accrual are demonstrated.

The current state of the law, it is submitted, requires that income be recognised for tax purposes at the time when the taxpayer becomes unconditionally entitled to the amount in question. Any accrual, including the right to claim payment in the future, should be valued at the time of accrual, and not at the end of the year of assessment, as is suggested by some authors.

The current state of the law is plagued with practical difficulties and results in a number of inconsistencies. The basic concepts relating to the recognition of income that are considered to be desirable are not adequately addressed under the current position.

The practice of taxing accruals employed by the revenue authorities selectively recognises [illegible] legal precedent and, it is predicted, will have to be amended soon. The complexities of the issues involved in the recognition of income are such that the matter cannot be dealt with adequately without considerable further investigation.

DECLARATION

I declare that this research report is my own unaided work. It is being submitted for the degree of Master of Commerce by Coursework in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in any other university.



P.BACKWELL

29 FEBRUARY 1988

PREFACE

This research report is concerned with the process of accrual. Whether it is income or capital or some other thing which accrues is an entirely separate (and fairly well addressed) question.

For nearly three quarters of a century there has been doubt regarding the interpretation of the gross income definition. At long last a taxpayer has challenged the Commissioner's practice in this respect. The matter is of great importance to all tax practitioners and academics. This research report has been undertaken in order to highlight the many problems involved in the accrual of income which has not been received.

No attempt has been made to resolve the problem, as research of this nature does not provide an appropriate basis for the formulation of suitable solution. It is submitted that substantial research is required before any answer can be found.

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1. INTRODUCTION

"Tax ought to be certain . This is a very important principle in modern tax law . Adequate tax planning would become an impossibility if the parameters within which the fiscus operates were not clearly defined . The degree of certainty required is achieved by means of the formulation of a set of rules which clearly indicates the method and manner in which tax is to be collected " (Smith , 1776) .

The principle of certainty in tax law is regarded by many authors to be fundamental to any form of tax legislation . The "set of rules " referred to by Smith is the statute that empowers the revenue authorities to extract the tax from the populace . In South Africa the Income Tax Act (Act no. 58 of 1962 , as amended) is one example of such legislation .

As its name implies , the Income Tax Act (hereinafter referred to as "the Act") is the taxing statute that applies to income . However , when one considers the nature of income , in the sense of the common usage of the word (or as viewed by economists or accountants) , and compares this to the manner in which the Act operates , it is abundantly clear that in South Africa taxes on income are determined not on income , but on a

purely artificial basis (Broomberg , , 1972). This artificial basis of taxation was identified by the court in Pyott Ltd v CIR (13 S.T.C 121 at 126) :

".... the whole business of our taxation was changed in 1917 . Under the Act of 1914 , the subject of the charge was "profits or gains" , and it was consequently the same as it is still today in England . But since 1917 , we have had in South Africa an artificial and purely statutory definition of "taxable income" , derived ultimately from the definition of "gross income" as set out above - that is , the total amount of receipts and accruals excluding those of a capital nature from any source within the Union (or deemed to be such) , and it is by no means necessarily synonymous with "profits or gains".... What has to be ascertained is the "taxable income" , and this has to be ascertained in the manner prescribed by the Act and in no other."

Although this case dealt with the predecessor to the Act in force at present , the determination of "gross income" is carried out in essentially the same manner . "Gross income" is defined in section 1 of the Act (all references to a section hereinafter , refer to a section of the Income Tax Act , unless otherwise indicated) as being :

"....the total amount , in cash or otherwise , received

by or accrued to or in favour of such person during such year or period of assessment from a source within or deemed to be within the Republic , excluding receipts or accruals of a captial nature...".

It is evident from this definition that there are two occasions on which income may fall into a taxpayer"s gross income , that is either when it is received or when it accrues . The significance of this portion of the definition of gross income is that it determines the timing of the recognition of the income . As is the case with many other aspects of the Act , the courts have been called upon to interpret the meaning of the words "accrued to". One of the earliest cases to examine the meaning of "accrued to" is the case of Lategan v CIR (2 SATC 16) . This case established a legal precedent still in force , determining that accrued means "become entitled to" . In subsequent cases (CIR v Delfos , 6 SATC 92 and Hersov's Estate v CIR , 21 SATC 106) it was suggested that the meaning of accrued is "become due and payable".

In the case of Mooi v SIR (34 SATC 1 , at 10) Ogilvie-Thomson CJ described the differing opinions regarding the meaning of "accrued to" as "this controversial question". However , the learned Chief Justice did not find it necessary to resolve this controversy.
It is evident, therefore, that the still

uncertainty after more than three quarters of a century of examination as to the meaning of "accrued to" as used in the gross income definition. The absence of clarity on this point violates the fundamental principle of certainty described in the opening paragraph of this chapter. Furthermore, as "gross income" is the starting point for the determination of liability for taxation under the artificial method of income determination employed by the Act, it is evident that this is the cornerstone of the tax, and the importance of achieving certainty in this regard is obvious.

2. THE AIM AND METHOD OF THE RESEARCH

This study is aimed, primarily, at demonstrating that the present state of the law regarding the meaning of accrual leads to results that are plagued with problems. Although there are a number of different aspects that may be examined in determining the meaning of "accrued to" in the gross income definition in section 1 of the Act, the focus of this study is on the timing of revenue recognition for the purposes of the Act, as well as the measurement of the quantum of income which has accrued prior to receipt.

This study has been conducted by examining and analysing :

1. The basic concepts relating to the timing of income recognition
2. The methods of accruing income in selected foreign tax jurisdictions
3. The current state of the law in South Africa
4. The anomalies and shortfalls in the interpretations of "accrued to", as established by the courts, and the recommendations formulated by the Margo Commission

The research has been concluded by :

5. Providing an interpretation of the current state of the law regarding the meaning of "accrued to"

6. Evaluating the current state of the law with reference to the theoretically desirable features identified in this report

7. Formulating recommendations relating to the timing of income recognition for taxation purposes in South Africa

3. THE TIMING OF REVENUE RECOGNITION - BASIC CONCEPTS

The early economists identified land, labour and capital as being the three factors of production. The rewards attributable to these factors are rent, wages and interest, and in a perfectly functioning economy these three factors should account for all of the income from production. They concluded that any residual income (over and above the rent, wages and interest) is due to the imperfections of the system. As economic theory developed entrepreneurship was identified as being a fourth factor of production, the compensation for which is profit (Myers, 1959).

Profits are earned over the operating cycle of the business enterprise, and it may be difficult to measure income on a periodic basis. Storey (1960) claims that the determination of periodic net income is the most important function of financial accounting. He is of the opinion that the basic step in the solution of income measurement problems is: "the achievement of an understanding of the nature of income and of the income determination process".

An examination of the nature of income and of the income determination process, as established by economists and accountants, demonstrates the evolution

in thinking that has resulted in a set of guidelines which could be used for the measurement of income for taxation purposes.

3.1. ECONOMIC PRINCIPLES

When *an economist speaks* of income, the term is used in approximately the same sense as when the word is used in everyday language. However many attempts have been made to give the term a precise meaning. Economists recognise that income is to a large degree intangible, being a flow of satisfactions (Haig, *1921*).

The definition of income as being a flow of benefits during *a period of time was* acknowledged by other economists, Fisher (1911) and Ely(1908) who claim : "Wealth refers to the stock of goods on hand at a particular time. Real income, on the other hand, has reference to the satisfaction we derive from the use of material things or personal services duing a period of time."

In his study, *Haig considered* the writings of Fisher and Ely, but was not satisfied that the flows of intangibles could be measured without the aid of some common unit. Haig approved of the conclusion reached by Taussig (1916) : ".... for almost all purposes of economic study, it is best to content ourselves with a

statement, and an attempt at measurement, in terms not of utility but of money income.....The reason for this rejection of a principle which is in itself sound lies in the conclusion .... regarding total utility and comsumer's surplus : They cannot be measured." Haig was then able to conclude that : "Income is the money value of the net accretion to one's economic power between two points of time". This definition was added to by Simons(1921), who suggested that the consumption and the net change in wealth should be evaluated at market prices, with the latter (wealth) being computed on an accrual rather than on a realised basis.

It is evident that there are a number of problems associated with the definition of income used by economists that may be encountered when income measurement is attempted. The change in wealth involves a valuation of assets at two points in time. The determination of market values may not be possible if the assets in question are not readily tradeable (White, 1959). It may also be found that the quoted values of tradeable assets may not be appropriate. Values of assets may fluctuate over time as a result of changes in price levels. The effect of inflation give rise to fictitious gains in monetary value rather than real capital accumulation (Goode, 1964). Finally, this broad view of income would include the increase in wealth from all sources, including receipts such as

donations and inheritances which are obviously not "earned" from the economic performance of the individual.

3.2. ACCOUNTING PRINCIPLES

The people whose function it is to measure income, accountants, have had to adapt the economic concepts in order to achieve a definition of income that may be applied in practice. In doing so, they have inevitably bastardised the pure economic concept of income. Economists define income in terms of value, essentially dependent upon expectations about the future. Accountants look in the opposite direction and define income in terms of the past. They rely on completed transactions to provide a factual value that has actually been implemented. In addition to the problems with the economic concept of income that have already been highlighted, accountants see a further problem in that the economic concept lacks objectivity and accuracy in the measurement of periodic income. The primary difference between the two concepts of income is the criterion of realisation (Sommerfeld, Anderson and Brock, 1978).

The accountants are concerned with the valuation of assets at a specific point in time, and the measurement of income during a fixed period. They therefore take a

"snapshot" of the business entity, which creates *numerous problems* and is becoming a source of concern to many accounting academics. The main criticism of periodic reporting is that the financial periods do not necessarily coincide with the transaction cycle of the reporting entity. Do the transactions of the entity mature instantaneously , or is there a *process of* realisation in which a gradual earning of the income takes place? This problem has not been fully resolved *by the accounting theorists,* however practical methods of handling the problem have been developed.

The recognition of income for accounting purposes has been described by Davidson, Hanouille, Stickney and Weil (1985) as involving "a timing question - when it is recognized- and a measurement question - how much recognised -". The timing and the quantum of income can only be *determined when all,* or a substantial portion, of the relevant transaction has been completed, and when cash, a receivable, or some other asset susceptible to reasonably precise measurement has been received (Davidson et al, p302).

Accountants have developed a set of guidelines to be followed in the measurement of the quantum and timing of income *in their Accounting Standards.* In South Africa the statement of Generally Accepted Accounting Practice, AC 111, entitled "Revenue Recognition",

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Accountants have developed a set of guidelines to be followed in the measurement of the quantum and timing of income in their Accounting Standards. In South Africa the statement of Generally Accepted Accounting Practice, AC 111, entitled "Revenue Recognition",

issued by the South African Institute of Chartered Accountants with effect from 1 January 1985 is the relevant set of guidelines. The following extracts from this statement are pertinent to the matter at hand:

"Revenue recognition is mainly concerned with *when* revenue is recognised in the income statement of an enterprise. Although the act of delivery is an essential element in *determing when* legal ownership passes, this statement permits earlier recognition of revenue if the transaction is substantially complete" *(paragraph 8)*.

"The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. Where uncertainties exist regarding the determination of the revenue, or costs incurred relating to that revenue, these uncertainties may influence the *timing of* revenue recognition" (paragraph 9).

"Where the uncertainty relates to collectibility and arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty than to adjust the amount of revenue *originally recorded*" (paragraph 23).

"In a transaction involving the sale of goods, performance should be regarded as being achieved when

the seller has transferred to the buyer the significant risks and rewards of ownership. In a transaction *involving the rendering of services*, performance should be regarded as the execution of an act or the passage of time and revenue should be recognised *either under* the completed contract method or under the percentage of completion method, whichever relates the revenue to the work accomplished" (paragraph 30).

"Revenue.....should be regarded as being measurable when no significant uncertainty exists regarding the *consideration* that will be derived from the sale of the goods, the rendering of services or from the use by others of enterprise resources,...." (paragraph 31).

"For an exchange of nonmonetary assets the fair value of the assets or services exchanged is normally used to determine the amount of revenue involved. For this purpose fair value is defined as the amount for which an asset could be exchanged between a knowledgeable, willing buyer *and a knowledgeable*, willing seller in an arms length transaction. Where the fair value of the assets on one side of the transaction is determinable, that fair value is used in determining the amount of revenue involved in an exchange of dissimilar assets. Exchanges of similar non-monetary assets or services are not regarded as transactions which generate revenue" (paragraph 28).

It is evident from these extracts from the Accounting Statement that accountants are committed to the concept of realisation in order to provide an objective measure (as far as is practically possible) to be applied in recognising the quantum and timing of revenue. The economic theory of income is openly sacrificed in the name of objectivity.

3.3. TAXATION PRINCIPLES

In chapter 1 the artificial nature of income determination for tax purposes was highlighted. Givens(1966) has suggested that the: "problem of differences between taxable income and book income could be generally ignored if accountants and the business community would recognise that the income tax is not a tax on income. It is, rather, a general business tax, based on income only in so far as the book income is the starting point used in determining the taxable base". He is of the opinion that the recognition of this would "free accountants from the impossible task of trying to find a significant relationship where none exists".

Although income for tax purposes is not necessarily income for accounting purposes, there are areas of common ground, particularly, it is submitted, in South Africa. Just as accounting income was derived by

shearing the hazy fringes from economic income, so too was *taxable income* derived by clipping out the accounting concepts incapable of codification.

The characteristics of income that are important from the point of view of tax policy have been identified as being (Sommerfeld et al, 1978):

1. Wherewithal to pay
2. Realisation and objectivity
3. Equity and uniformity among taxpayers
4. Ease and consistency of administration
5. Social and economic objectives

(These aspects are discussed in detail in chapter 4)

From the description of the three concepts of income, economic income, accounting income and tax income, it is evident that the definition of economic income is the broadest. Accounting income could be seen as a subset of economic income, as it excludes items of income that cannot be measured with accuracy. A significant portion of the income that is recognised for accounting purposes would constitute a substantial part of tax income, the differences between the two being the items excluded or included in terms of the five aspects detailed above. It is evident that there are areas that are common to all three concepts of income, and that accounting income and tax income concepts have been derived from the concept of economic income.

Givens' contention that there is no significant relationship between accounting *income and tax income*, other than that accounting income is the starting point in the determination of tax income, it is submitted, in the *South African context*, it is not altogether correct. The fact that accounting income is the starting point indicates that there must be at least some common ground, otherwise some other starting point would have been chosen.

The use of accounting income as the starting point for the determination of tax income has arisen, not from the Act, but *from common* practice and the method adopted in the Return of Income (IT 14) that is required to be submitted to the South African Revenue authorities in respect of corporate taxpayers.

It is acknowledged that the artificial basis of *income* determination for the purposes of the Act begins with the determination of "gross income", with exempt *income being deducted*, to arrive at "income", and then deductions and allowances are subtracted to result in "taxable income".

The method that accountants traditionally use to determine income may be found in the income statement. A detailed income statement may be broken down into two broad areas, income and expenditure, with the latter

being deducted from the former to achieve the result of "net income before tax".

It is evident that the tax and the accounting methods of determining income are roughly similar - both begin with a measure of gross receipts and then deduct certain items. It is the measure of gross receipts that is of significance to this study. The similarities, and the important differences, between the measure of gross receipts for accounting purposes and for the purposes of taxation are examined in detail in the following chapter.

4. RECOGNITION OF REVENUE FOR TAXATION PURPOSES

The differences between the recognition of income for accounting purposes and for taxation purposes have arisen from many varied influences. The major influences are the underlying body of economic and legal philosophies of the legislature, variations in the interpretation of the law by the courts, and the increasing use of tax policy as an instrument of economic planning and control (*Sommerfeld et al*, 1978).

4.1. WHEREWITHAL TO PAY

The "ability to pay" principle has been accepted as being fundamental to taxation philosophy for many years. This concept denotes the idea that the more a taxpayer earns, the more taxation he should pay. However in the context of this study an apparently similar phrase, "wherewithal to pay", has a different meaning. Cohen (1966) describes the latter phrase: "As a practical matter, the timing of the tax should occur when the taxpayer can most readily pay and the I.R.S. can most readily collect".

It can be seen that the principle of wherewithal to pay requires that the taxpayer must not only have the ability to pay (ie. have earned the income) , but must

also have the money to finance the tax payment. This principle explains many of the circumstances where income recognition for tax purposes differs from the accounting treatment. Where income is received prior to it being earned, it should generally be recognised for tax purposes (although not for accounting purposes). This method of taxation is presumably designed to ensure that the tax will be collected, as the taxpayer has the cash available at the time of receipt, but may no longer have the wherewithal to pay at a later time when the income is finally earned. Alternatively, the taxpayer may still have the funds at the later date, but may have departed from the tax jurisdiction by that later date (Sommerfeld et al, 1978).

On the other hand, the wherewithal to pay principle would enable a taxpayer to defer the recognition of income for taxation purposes in the case of exchange or barter-type transactions. In the event that income is earned by the conversion of property, for example when land is exchanged for shares, it is evident that the taxpayer may have to dispose of a part of the asset received in exchange in order to finance the payment of taxation on the profit (although the possibility of borrowing, using the asset as collateral, may negate the necessity to sell the asset).

The wherewithal to pay principle is only applied to a certain degree in the Act. In the gross income definition in section 1 amounts "received by or accrued to" a taxpayer are brought into account. It is evident that if a taxpayer receives income before it is earned, he is liable for tax thereon. However, on the other side of the coin the principle is ignored in that the gross income definition brings into account amounts received "in cash or otherwise". Thus, even though a taxpayer may *have received an asset other than cash*, he would still be liable to pay tax (in cash) on the income (section 24A alleviates this problem only in certain circumstances).

4.2. REALISATION AND OBJECTIVITY

The concept of realisation which was raised in chapter 3.2., is closely related to the principle of wherewithal to pay. The realisation criterion requires that income only be recognised when it is realised through a conversion into new assets or a liquidation of *existing liabilities* (*Sommerfeld et al, 1978*).

It can be seen that an increase in the value of an asset, even if it is readily measurable, should not be subjected to income tax. Thus where a sharedealer benefits from an increase in the market value of his shares, he has no income to be taxed until such time as

he realises the gain by converting the shares to cash or some other asset. At the same time, declines in the value of assets are generally *recognised, even* though they are unrealised, if the assets in question consist of the floating capital of the business. This principle *therefore creates an* inconsistency in the treatment of unrealised changes in value.

Apart from the link with the wherewithal to pay principle, the realisation concept is also firmly founded upon the principle of certainty *described in* chapter 1. This comes about because of the objectivity that arises from the realisation concept which *provides accuracy and* certainty in both the quantum and timing of income recognition. The realisation concept applied for purposes of taxation is very similar to its use by accountants, however one important exception exists. In the case of exchange or barter transactions income may not necessarily be recognised for accounting purposes, but it is necessary to recognise the income for tax purposes (in practical terms this difference *may have an insignificant effect* in South Africa as the exceptions would normally result in "capital" income which would be excluded from gross income). Even though this is contrary to the wherewithal to pay principle, from a practical point of view it is necessary to recognise income at the date of exchange to prevent the tax avoidance that would otherwise arise

by "rolling" income from year to year by way of exchange rather than sale.

Therefore, in the event of an exchange of assets, the revenue authorities have, as a matter of necessity, to forego the objectivity consideration, as well as the wherewithal to pay principle, in order to close a "loophole" that could possibly be very expensive in terms of delayed tax collections.

The effect of the transaction cycle is also of importance to the recognition of income for tax purposes. In considering the concept of realisation one must consider when transactions are actually complete. Is there a stage in the transaction when it can be said that the income is actually earned? It is unlikely that the timing of the assessment period will coincide with the earnings cycle. Irrespective of when the transaction or earnings cycles mature, there will always be a need to have a cut-off date if taxable income is to be determined regularly. It is submitted that the need to fix the determination of tax chargeable on a regular basis,normally on an annual basis, is so important that the problems that arise from the periodic income determination process have to be accepted.

4.3. EQUITY AND UNIFORMITY

The concept of equity in taxation is generally regarded as being fundamental to any tax system. This concept requires that equal incomes should bear equal taxes (Sommerfled et al, 1978). It is evident that this principle has been sacrificed in many instances where the Act specifically provides for the unequal tax treatment of income. Certain classes of taxpayer may receive income free of tax, while the same type of income is taxed in the hands of other taxpayers. Interest income may or may not be subjected to tax, depending upon the identity of the payer of the interest. These apparent violations of the equity concept are often justified or rationalised by reasons that are perceived to be of greater importance than the fundamental tax principles (for instance, the exemption from tax of interest paid by the Post Office attracts funds, as well as allowing the payment of interest at a lower rate).

4.4. EASE AND CONSISTENCY OF ADMINISTRATION

Hand in hand with the idea of equity and uniformity goes the need for the tax treatment of an event to be "fixed with adequate certainty in order to avoid disputes as to the occurence of the event or the amount involved" (Cohen, 1966). The achievement of this goal

may require greater divergence between accounting measures of income and the tax recognition.

The tax requirements for the recognition of income may be less flexible than the accounting rules because strict rules are capable of being administered more easily. The differences that arise because of the need for administrative convenience should result in more uniform results being achieved among different taxpayers, as fewer subjective judgements would be required (Shapiro, 1959). Accountants are specifically requested (in AC 101) to apply the spirit rather than the letter of the accounting standards. Taxpayers could hardly be requested to apply some sort of fiscal spirit (especially in the South African context).

4.5. SOCIAL AND ECONOMIC OBJECTIVES

It would seem that the tax system is being used to an ever increasing extent to achieve specific social or economic objectives. This aspect was touched upon briefly in chapter 4.3., in respect of interest income that is exempt from tax.

Social or economic goals may be attained by measures that permanently affect the taxation payments by certain classes of taxpayers. There is considerable criticism about the use of tax legislation in this

manner, while it must be acknowledged that this may be a very effective economic tool. The use of the tax legislation to achieve social and economic goals may be a further cause for differences existing between the recognition of income for tax purposes and the accounting income recognition (Sommerfeld et al, 1978).

This aspect may have some impact on the recognition of income in certain foreign tax jurisdictions, but should not have a significant effect on the South African income tax. The artificial structure of tax determination used in South Africa ensures that the income is first recognised as "gross income", and the social and economic objectives are achieved by a later exemption of the income, or by the granting of a special deduction or allowance.

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5. REVENUE RECOGNITION IN CERTAIN FOREIGN JURISDICTIONS

The examination of any problem may be assisted by considering the experience of others who have faced similar problems. It is therefore considered appropriate to examine how revenue is recognised for tax purposes in other countries. For the purposes of this study only three other tax jurisdictions will be examined, namely Australia, the United Kingdom and the United States of America. From a brief preliminary examination it is evident that the experience of countries other than those mentioned may be of some value to the examination being undertaken. However, they have been excluded from this study because certain practical difficulties were encountered.

The study of the foreign tax jurisdictions has been limited to countries that use English as their official language. The problem encountered with non-English tax law is that there is a limited source of material available in English, and what is available is of little benefit as it is generally very brief. Also the supply of good source material (court cases, commentaries, articles and reference books) available in local libraries is mainly limited to the three countries being examined. In the event that further research is undertaken in this field, it is suggested

that the examination of foreign tax jurisdictions be extended to include other sophisticated tax regimes.

5.1. *AUSTRALIA*

Income tax is levied upon the income derived during the year by a taxpayer in terms of section 17 of the Australian income tax legislation (Mannix and Mannix, 1982). Section 19 of this act deems certain income to have been derived: "19. Income shall be deemed to have been derived by a person although it is not actually paid over to him but is reinvested, accumulated, capitalised, carried to any reserve, sinking fund or insurance fund however designated, or otherwise dealt with on his behalf or as he directs".

In the case of COT v Executor Trustee & Agency Co. of S.A. (5 ATD 98, at 133) it was said that "the word "derived" is the equivalent of "arising" or "accruing" ". Mannix and Mannix (1982) explain that income arising from business transactions is derived "as and when the contract which gives rise to the income is completed, but not to the extent that payment has been made under the contract". The effect of this interpretation of derivation of income by a business is that *businesses are assessed* on a credit basis, i.e. there are brought to account moneys owing as at the end of the year of income in respect of transactions completed in the year of income, and similarly where

money has been brought to account in a year of income an adjustment is necessary in the next year of income where moneys are received in that year. The actual receipt of money is not a derivation of the income".

In the case of Australian Machinery & Investment Company Ltd v DFCT (8 ATD 81, at 85) the court found : "Since the appellant company was carrying on the business of trading in shares, its profits should be ascertained, not by the cash-basis mode but by the earnings-basis mode, which is the usual mode applicable to the assessment of profits of a trading business which buys and sells..... Any income derived from the Comet transaction which is liable to Federal income tax is liable in the year in which the appellant company became legally entitled to the immediate receipt of the moneys which created the profit, not necessarily the year in which the contract was made or the year in which the moneys were actually received" (underlining added).

In J.Rowe & Son Pty Ltd v FCT (2 ATR 297) the transactions in question involved the sale of retail goods on extended credit terms, with interest being charged on the outstanding balance on the account. The court decided that the profit from the sale was derived in the year in which the sale took place, while the interest was assessable as and when received over the period of the time of the repayments.

Wallschutzky (1986) notes that the rules for the derivation of income cannot be generally applied. Each type of income must be considered and the appropriate treatment, according to the circumstances of each case, should be applied. It appears as if a wealth of case law has been accumulated to cater for the derivation of the many different types of income.

Section 21 of the Australian taxing statute deals with transactions where the consideration given is not cash. The market value of the asset at the time it is received is used in the determination of the assessable income (Mannix and Mannix, 1982).

5.2. UNITED KINGDOM

In the computation of profits, for the purposes of determining income tax arising from the carrying on of trading operations , the general rule followed is that the amounts "earned" must be taken into account, and not only amounts received (Pinson, 1980) . The question of the timing of revenue recognition was addressed in the case of J.P. Hall & Co ltd v IRC (12 TC 382) in respect of a transaction involving the sale of goods. In this case the court found that the profits arose, not at the date of the contract, but at the date of delivery of the goods.

It is important to note that the date on which the revenue should be recognised for tax purposes may differ from one transaction to another, and that the decision in the J.P. Hall case is not necessarily of general application. Tiley (1985) states that the date on which income is earned depends upon the terms of the particular contract. It is only when all the conditions precedent to earning the income have been fulfilled that the income should be recognised for tax purposes. This principle was confirmed in the cases of Johnson v W.S. Try Ltd (27 TC 167) and Willingale v International Commercial Bank Ltd (1978 STC 75). In both of these cases the recognition of income was delayed until the year in which the proceeds from the transaction were actually realized.

The rule generally applicable to the sale of goods on credit is described in Simon's Taxes as follows:
"Normally an item becomes a trade receipt on the day when it becomes a debt receivable even though the date of receipt is postponed. Accordingly, when a sale is made, the sale price has to be brought into account at that date, and it will from part of the total of the sales in the profit and loss account for the then current period; and that will be so even if the sum is not paid to the trader until after the end of the current accounting period..... The debts remaining due to the trader at the end of the accounting period in

question are brought in at their full face values except to the extent that they are then bad or doubtful."

It is interesting to note that there is a mechanism in the U.K. tax system to provide, to a certain extent, for the matching of income and expenditure for tax purposes. The matching concept, which is one the fundamentals of accounting, is generally disregarded by the artificial method of recognising income for tax purposes. Tiley (1985) explains that this matching mechanism (referred to as the doctrine of relating back) "matches receipts with the moment the services have been rendered or the goods supplied, and not with the moment that a legally enforceable right to payment arises". The consequences of the relating back principle is that, generally speaking, income earned subsequent to the incurring of the associated expenditure may be moved back in time , for the purposes of revenue recognition for tax purposes, so as to coincide with the time of incurral of the expenditure. This matching principle does not apply to receipts or accruals that occur prior to the outlay of the expenditure.

In circumstances where the taxpayer receives income in the form of an asset, rather than money, the amount recognised as income for tax purposes is based on the

actual value of the asset received. The case of Gold Coast Selection Trust Ltd v Humphrey (30 TC 209) established the general principle to be followed:

"In cases such as this, when a trader in the course of his trade receives a new and valuable asset, not being money, as the result of sale or exchange, that asset, for the purpose of computing the annual profits or gains arising or accruing to him from his trade, should be valued as at the end of the accounting period in which it was received, even though it is neither realised nor realisable till later. The fact that it cannot be realised at once may reduce its present value, but that is no reason for treating it, for the purposes of income tax, as though it had no value until it could be realised..... If the asset is difficult to value but is none the less of a money value, the best valuation possible must be made. Valuation is an art, not an exact science. Mathematical certainty is not demanded, nor, indeed, is it possible. It is for the Commissioners to express in the money value attributed by them to the asset their estimate, and this is a conclusion of fact to be drawn from the evidence before them".

5.3. UNITED STATES OF AMERICA

The Internal Revenue Code , in section 61(a) , defines gross income as being : "all income from whatever

source derived". The recognition of income is permitted on a number of bases, including the accrual or the cash methods, in terms of section 446 of the Code. It has been recognised that no single method of accounting can be prescribed for all taxpayers. Each taxpayer is entitled to adopt the method of recognising income that is best suited to his needs. However, the method adopted must reflect income clearly and consistently (Treasury Regulations, s 1.446-1). The accrual basis must be used by certain types of taxpayers, especially taxpayers with inventories of stock in trade (Sommerfeld et al, 1978).

The Treasury Department has provided the following interpretation of the gross income definition:
"Gross income includes income realised in any form, whether in money, property or services. Income may be realised, therefore, in the form of services, meals, accomodations, stock, or other property, as well as in cash" (Treasury Regulations, s1.16-1(a)). It is evident that this interpretation relies on the realisation *concept. Essentially, there must be the receipt of cash,* some other asset, or a right. This view has received the support of the courts. For instance, in Eisner v Macomber (252 U.S. 189), the Supreme Court said:
"Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment: but a gain, a profit, something of

exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being "derived", that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal; - that is income derived from property. Nothing else answers the description".

In determining gross income, it is not necessary that the exact amount of income be known for it to be accounted for. As long as it is possible to make a reasonable estimate of the amount accrued, the estimate should be used. Any difference between the estimate and the exact amount received in the later year is to be taken into account in that later year (Standard Federal Tax Reporter, p 35, 122).

It should be noted that apart from the requirement that the amount of the income must be determinable with reasonable accuracy, there is a further requirement. All the events that ensure the right to receive the income must have occurred in order for the income to be recognised for tax purposes.

The gross income of a taxpayer who uses the accrual basis should include sales during the year, which are stil unpaid at the end of the year of assessment, at their face value (Charles C. Lewis Co v U.S., 36-1 USTC 9219). In the cases of Spring City Foundry Co v Com (4

USTC 1276) and Helvering v Enright (41-1 USTC 9356) it was found that the time when accrual takes place is when the right to receive payment arises, and not at the time of the actual receipt.

5.4. COMMON ASPECTS

Although each of the three foreign tax jurisdictions discussed is unique, there are certain aspects relating to the recognition of income that are common to all. The first important similarity is that income is admitted for tax purposes when the taxpayer becomes entitled to receipt of the amount, irrespective of whether the payment is due in that tax year. Secondly, income that has been taken to account, but has not been received by the year end, is recognised at the face value of the debt. And thirdly, when income is received or accrued in a form other than cash (excluding debts), the value of the asset, at the date of receipt or accrual, is taken into account.

6. GROSS INCOME DEFINITION

6.1. HISTORY

The history of the law regarding income tax, and specifically the method of recognising income, is of relevance to this study as a number of the important court decisions were made in terms of legislation that has changed over the years.

Prior to the Union of South Africa being established there was no taxation of income in the Transvaal and Orange Free State. However, in Natal and the Cape of Good Hope there was an income tax imposed on individuals and companies. The Mining Taxation Act (Act No. 6 of 1910) consolidated the law regarding mining taxation for the Union, and the first general income tax was imposed by the Income Tax Act, No. 28 of 1914.

The income tax and mining tax laws were consolidated in 1917 (by Act No. 41 of 1917). The next consolidated Act was Act No. 40 of 1925, followed by the Income Tax Act, No. 31 of 1941. The 1941 Act remained, with regular amendments, until the present Income Tax Act (No. 58 of 1962) was brought into force (Isaacs, Fielding and Lazar, 1963).

The Cape of Good Hope Act No 34 of 1904 levied a tax based on: "any gains or profits derived or received by any company or person in any year or by any means from any source within this Colony, and includes profits, gains, rents, interest, salaries .....". The Additional Tax Act (No. 36 or 1904) refined this method of taxing by moving from the "gains or profits derived" base to "a tax based on ..... incomes arising or accruing.....". In Natal the income tax (in terms of Act No. 33 of 1908) was based on "gains or profits derived or received" (Edmunson, 1986).

The Income Tax Act of 1914 provided for ".....a tax to be charged, levied and collected throughout the Union on Taxable Income which has been received by or accrued to or in favour of any person....." (Edmunson, 1986). In this Act, income was defined as "gains or profits". The "gains or profits" basis of determining income was discarded when the Act was redrafted. The artificial method of determining income was introduced, with income being defined as "what remains of the gross *income after certain deductions*", in the 1917 Act. Gross income was defined in this Act as being "the total amount received by or accrued to or in favour of any person other than receipts or accruals of a capital nature..... and includes rents, interest, salaries .... whether in money or otherwise"(de Koker, 1983).

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The 1925 Income Tax Act defined gross income as being the total amount whether in cash or otherwise received by or accrued to any person, other than receipts or accruals of a capital nature. It would appear that the addition of the phrase "in cash or otherwise" may have assisted in clarifying the definition to some extent, but there still remained considerable problems, as far as the courts were concerned. In 1932, in the case of Ochberg v CIR (6 SATC 1 at 6) Watermeyer J. stated that this "apparently simple definition bristles with difficulties".

There have been no material amendments to the gross income definition since the 1925 Act.

6.2. THE LATEGAN PRINCIPLE

The important role that the courts play in the South African tax system requires that a close examination of the relevant court decisions be made. The most important decision handed down by the courts to date regarding the accrual of income is that of W.H. Lategan v CIR (2 SATC 16) . This case was one of the first to deal with the subject, and is generally regarded as having created legal precedent that is still intact. The principle established in this case has come to be known as the "Lategan Principle".

The case dealt with the year of assessment ended on 30 June 1920, and was therefore subject to the provisions of the 1917 Act. The relevant portion of the gross income definition ("...accrued to or in favour of...") remains unaltered in the current legislation.

The taxpayer in this case, Lategan, was a wine farmer who had, during the year of assessment in question, sold wine to a co-operative (KWV) of which he was a member. A portion of the selling price was payable, subject to certain deductions, during the tax year, while the balance was payable in instalments subsequent to the end of the tax year. The aforementioned deductions comprised two elements, namely "retention" and "contribution" monies. These deductions were made in terms of the KWV's constitution for the purpose of providing working capital for the co-operative, as well as to finance the annual expenditure. Lategan was entitled to receive shares in KWV in return for a portion of the deductions.

In assessing the taxpayer, the Commissioner included the full selling price in the gross income, and allowed to be deducted only the portion of the abovementioned deductions that were in respect of the contribution towards the KWV's annual costs.

On appeal against the decision of the Special Court, the Cape Provincial Division of the Supreme Court was faced with two questions to answer. Firstly, whether the instalments payable after the end of the tax year constituted gross income, and secondly, whether the retention monies deducted by KWV were gross income or alternatively whether these monies qualified for deduction. It is the first question that is of prime importance to this research.

In analysing the gross income definition Watermeyer J determined that the word "amount" in the definition had to be given a wide meaning so as to include not only money, but also the value of property received by or accrued to a taxpayer, as long as it has a money value. This view would then result in the value of any form of property, including debts and rights of action, being included in gross income.

The appellant argued that the debt payable after the end of the tax year was not an amount that had "accrued to" him during the year. But the learned Judge was of the opinion that the words in the Act "has accrued to or in favour of any person" meant "to which he has become entitled". Following this logic, it was found that Lategan had accrued a right to receive payment after the year end. This right was his income, and had to be valued for the purposes of inclusion in gross

income. Therefore, the amount to be taken to account was not the face value of the debt outstanding at the year end, but was the value of the debt at the year end (i.e. the face value less some deduction to bring the debt to its present worth at that date).

It is evident that three important aspects regarding the gross income definition were established in this case: gross income consists of "value", irrespective of the form of the income earned; the time that income is recognised is when the taxpayer becomes entitled to the income; and that in determining the value of debts outstanding at the year end, some amount has to be deducted from their face value.

6.3. THE "DUE AND PAYABLE" INTERPRETATION

The judicial doubts cast on the Lategan Principle may be found primarily in the cases of CIR v Delfos (6 SATC 92) and Hersov's Estate v CIR (21 SATC 106). The judgements in these cases, both heard in the Appellate Division of the Supreme Court, expressed some support for the view that income accrues when it becomes due and payable.

The Delfos case involved the accrual of salary and directors' fees to the respondent (Delfos). For a period of six years Delfos earned a fixed renumeration,

but only a portion of the renumeration was paid to him by his employer. The employer was experiencing financial difficulties and it was not clear whether Delfos would ever receive the unpaid balance. However, during the seventh year the respondent was paid the total accumulated arrear remuneration.

The court was faced with two questions of law to be answered. The first was: "Did amounts which were credited to (Delfos) in the books of the company in the previous years, but which were not paid to him in those years, accrue to or in favour of (him) in those years?"; and the second question is not entirely relevant to the matter under examination, and has therefore been ignored in this paper.

Both the Special Court and the Transvaal Provincial Division answered the first question in the affirmative. The Appellate Division supported this finding unanimously, however, the reasons for agreement differed. The presiding judges were Wessels CJ, Curlewis, Stratford, Beyers and de Villiers JJA.

In his judgement, the learned Chief Justice said (at 6 SATC 99/100): "I agree with what is said....in Lategan's case....that the words "has accrued to or in favour of any person" merely mean the amount to which he has become entitled".

The judgement of Curlewis JA reads : " I agree that this appeal must be allowed, and in the main on the ground set out in the judgement of the Chief Justice. As regards the first question of law submitted for decision by the Special Court, as we are unanimous that this must be answered in the affirmative, there is no occasion for me to add anything to what my brethren have said on the subject."

De Villiers J.A. stated that in his opinion the word "accruing" as used in the gross income definition means "becoming due and payable". Income therefore accrues to a taxpayer at the moment when it becomes due and payable, irrespective of whether the debtor is in a financial position to pay it.

The interpretation of the word "accrued" by de Villiers JA was accepted by Stratford J.A. as being correct. Beyers JA said (at 6 SATC 113) "Dat die eerste vraag bevestigend beantwoord moet word val nie te betwyfel nie", but did not expressly comment on either of the alternative interpretations of the word "accrued".

It is evident that de Villiers and Stratford JJA favoured the "due and payable" interpretation, while Wessels CJ agreed with the Lategan principle. It would appear that Curlewis JA may have agreed with the Chief Justice, but this is not altogether clear. It

seems, also, that Beyers JA did not commit himself one way or another. There was therefore no majority decision on the matter.

The case of Hersov's Estate v CIR dealt with an amount paid to the estate, in terms of an agreement between the deceased and a company of which he was formerly a director. Apart from annual remuneration for services as a director, the agreement provided for a payment by the company to Hersov's Estate on the event of his (Hersov's) death. Shortly after the death of Hersov the company paid the amount in question to his estate. The Commissioner assessed the amount as income during the period of assessment ending at the date of the taxpayers death.

The executor of Hersov's estate claimed that:

1) the amount was of a capital nature;
2) that Hersov did not receive the amount, nor did it accrue to him;
3) and, alternatively, that if the amount was of revenue nature and did accrue to Hersov, it accrued on the date of the conclusion of the contract.

The decision in favour of the taxpayer was unanimous. Certain portions of the judgement delivered by Centlivres C.J. are important:

"In my view there was no accrual of any right to Hersov

to receive the amount: the accrual was in favour of his estate and that accrual only took place when the amount became due and payable.....I am aware of the fact that this suggested date of accrual conflicts with the decision in Lategan v CIR.....".

In discussing the Delfos case, the Chief Justice said: "Bearing in mind the differences of opinion and in view of the fact that there does not seem to be a majority view in favour of the decision in Lategan's case I do not think that it can be said that Lategan's case was accepted by this Court in Delfos's case as correctly laying down the law.

"If on the proper interpretation of the word "accrued" in the definition of "gross income" in section 7 of Act 31 of 1941 that word means "became due and payable" then it is clear that there was no accrual of the amount paid under clause 2 (c) of the 1936 agreement until some time after Hersov's death. It is, however, not necessary to arrive at the definite conclusion that this is so, because in my opinion it is clear that there was no accrual in favour of Hersov during his lifetime. I may also point out that in Lategan's case the accrual that was there held to have taken place was not subject to any condition. In the present case the accrual was subject to the condition that Hersov's death took place before the winding up of the company" (underlining added).

It is evident from an examination of the judgments of both the Delfos and Hersov's Estate cases that the "entitled to" interpretation of the word "accrued" was challenged. However, neither of these cases went so far as to create new legal precedent on the matter, and thus the Lategan principle remains intact. Kriegler J, in an unreported judgment of the Transvaal Income Tax Special Court stated that the Lategan Principle: " has been doubted judicially and criticized in learned publications but essentially it stands bloodied but unbowed" (Vorster, 1987).

6.4. THE MEASUREMENT OF GROSS INCOME

As stated in chapter 3.2., there are two major problems associated with the recognition of income, a timing problem, (when the income is recognised) and a measurement problem (how much income should be taken into account). The Delfos and Hersov's Estate cases dealt primarily with the former problem, while the Lategan case addressed both problems. The court in the Lategan case required the inclusion of the debt still unpaid at the year end in gross income at its face value less some deduction to bring the debt to its present worth at that date. Thus, cognisance was taken of the obvious commercial reality of the time value of money.

It is evident that the "due and payable" interpretation does not necessitate that account be taken of the time value of money, as the recognition of the income takes place at the time the amount is payable. There is hence no time difference to affect the value of the accrual, and the unpaid debts included in income (i.e. those that have already become due and payable) should be included at their face value.

However, the gross income definition includes not only receipts or accruals denominated in cash, but also other types of property. In CIR v Butcher Bros (Pty) Ltd (13 SATC 21) the court concluded that the words "cash or otherwise" in the gross income definition include anything which has an ascertainable value in money or money's worth. The property to be included in gross income may take any form, corporeal or incorporeal, as long as it has a money value.

It is interesting to consider the words used in the gross income definition. Account has to be taken of amounts "received by or accrued to" a taxpayer whether "in cash or otherwise". Has the disjunctive in these two phrases been used in a similar manner in order link the two concepts in any way? In other words, should "received" and "cash" be linked, and similarly, should "accrued" be linked to an asset other than cash? There would seem to be some validity in the idea that an accrual is the receipt of something other than cash.

The valuation problem arising from assets other than in cash was addressed in Lace Proprietary Mines Ltd v CIR (9 SATC 349), where it was found that the appropriate value is the amount that could be obtained for the asset on the open market if it were to be sold under some reasonable method of sale.

Silke et al (1982) submit that the date on which the valuation of an accrual, other than in the form of cash should take place is the date of the accrual. Some support for this submission may be found in Lace Proprietary Mines Ltd v CIR (9 SATC 349) and Mooi v SIR (34 SATC 1). However, the Lategan case required that the value of unpaid debts be determined at the year end.

Although there are significant differences between the rules attaching to the gross income definition and the general deduction formula, it is interesting to note that in considering the question of the deductibility of expenditure denominated in a foreign currency the court, in Caltex Oil (SA) Ltd v SIR (37 SATC 1), found as follows:

"It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amount received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment.....".

It would appear that Watermeyer J may have changed his opinion regarding the date of valuation of debts unpaid at the year end since he gave his decision in the Lategan case. In Ochberg v CIR (6 SATC 1) it would seem that Watermeyer J implied that the valuation should take place at the date of the conclusion of the transaction when he said (at 6 SATC 7):

"So soon as an unconditional sale has been concluded there vests in the seller the right to claim the purchase price in defined instalments at defined future dates: in other words the right to claim these instalments accrues to him. If the sale is for cash, the full purchase price accrues to him, if the sale is on credit, payable in future instalments then an allowance must be made therefor because what accrues to him is really only the present value of the right to claim payment in the future".

A practical solution to the problem of the valuation of uncollected debts has been suggested by Vorster (1987): ".....taxpayers are entitled.....to include in their gross income only the market value of book debts as at the last day of the year of assessment. In establishing that market value, taxpayers would be well advised to obtain competitive quotations for their book debts from banks and other concerns purchasing and collecting book debts and, perhaps, to accept an average value based on those quotations".

It is contended that although Mr Vorster's submission is convenient in practice, it is possibly not correct in law, as the valuation would appear to take place at the incorrect date. It would seem as if the valuation of the accrual should be made at the time of the accrual, rather than the end of the year of assessment. This aspect is examined further in chapter 7.3.

Another timing problem that has to be addressed arises from the requirement of the gross income definition that cognisance should be taken of income "received by or accrued to" a taxpayer. Where the receipt of the income does not take place at the same time as the accrual, even if both events take place in the same year of assessment, the time difference between the two dates may, in certain circumstances, give rise to a valuation problem (due to the concept of the time value of money).

Wessels C.J. came to the conclusion (in CIR v Delfos, 6 SATC 92, at 102) that the use of the disjunctive, "or", enabled the taxation of income to take place either at the time of the receipt, or the time of the accrual. It would seem, from the judgment in SIR v Silverglen Investments (Pty) Ltd (30 SATC 199), that the income becomes taxable at the time of the event (either receipt or accrual) that occurs first. It has been submitted by O'Donovan (1969) that the Commissioner for

Inland Revenue has no discretion as to whether the tax is leviable at the time of receipt or accrual, but is bound to recognise the income at the time of occurrence of the earlier event.

7. ANOMALIES AND SHORTFALLS

The matters raised in this chapter are intended to highlight problem areas, or potential problem areas, in the existing legislation and case law, and the Commissioner's prevailing practice, regarding the accrual of income. In some cases it has been possible to suggest a solution to a particular problem. In other cases, where there is no apparent answer, the problem has been left unresolved. It may be that there are no solutions to some of the problems, but it is considered important that the problem areas are recognised, so that they may be avoided in the event of any changes being made to the existing position.

7.1. OTHER SECTIONS OF THE ACT

Section 7 (1): "Income shall be deemed to have accrued to a person notwithstanding that such income has been invested, accumulated or otherwise capitalized by him or that such income has not been actually paid over to him but remains due and payable to him or has been credited in account or reinvested or accumulated or capitalized or otherwise dealt with in his name or on his behalf, and a complete statement of all such income shall be included by any person in the returns rendered by him under this Act" (underlining added).

It is evident that if the Lategan Principle provided the correct interpretation of "accrued", then section 7(1) is superfluous. It may be argued that the existence of this section lends weight to the "due and payable" interpretation.

Meyerowitz and Spiro (1987) submit that section 7(1) does not enlarge the meaning of "accrue", as it does not deem an accrual to take place in the given circumstances, but deems the accrual notwithstanding these circumstances.

The use of the words "remains due and payable" in the section cannot be considered to lend any support to the "due and payable" interpretation. The section continues, immediately after these words, to describe circumstances where the income would not be due and payable, although the taxpayer would still be entitled to the reinvested, accumulated or capitalized income.

It appears as if the reason for the existence of section 7 (1) is to clarify or confirm the treatment of the income, rather than to expand upon the gross income definition. The Income Tax Special Court has found, in ITC 563 (13 SATC 319), that the equivalent section in the 1941 Act was of no assistance in determining the meaning of the term "accrued" because of the obscurity of the section.

Section 24(1) : "If any taxpayer has entered into any agreement with any other person in respect of any property the effect of which is that, in the case of movable property, the ownership shall pass or, in the case of immovable property, transfer shall be passed from the taxpayer to that other person, upon or after the receipt by the taxpayer of the whole or a certain portion of the amount payable to the taxpayer under the agreement, the whole of that amount shall for the purposes of this Act be deemed to have accrued to the taxpayer on the day on which the agreement was entered into".

Again, it may be argued that this section is superfluous if the Lategan Principle is correct. However, there is an important difference between the accrual of income under section 24(1) and the equivalent accrual in terms of the Lategan Principle. Although the timing of the accrual would be the same under both methods, the quantum of the accrual would differ. The Lategan Principle requires that the present value of the payments be taken into account, while section 24 (1) requires "the whole of that amount" be included in income. The reason for this difference is clear. Section 24 provides for a special allowance to be granted to take account of the uncollected amounts at the end of each year of assessment. The existence of this allowance negates (partly) the need for a present value determination of the accrual.

The manner in which section 24(1) operates is also necessary for another reason. The suspensive condition involved in the transactions dealt with by section 24 may prevent the accrual from being recognised under the normal rules of accrual (due to the principle in Mooi v SIR, 34 SATC 1). However, the workings of section 22, dealing with trading stock, would be such that the stock sold would not be accounted for after the sale. Thus section 24 plays an important role in matching the income with the expenditure in the case of suspensive sale transactions.

It would seem that the existence of section 24(1) does not support either the "due and payable" interpretation or the Lategan Principle.

Sections 11 (i) and (j) provide for deductions for bad and doubtful debts "due to the taxpayer". It is submitted that the use of the words "due to" can offer no assistance in determining the meaning of "accrued". It would seem as if debts cannot be considered to be bad until such time as they are due and payable, thus giving good reason for the choice of wording used in the sections in question. Also, the calculation of a deduction under the artificial system of income determination is so far divorced from the recognition of income that there may be no relevance in attempting to achieve a comparison between the two aspects.

7.2. DEPARTMENTAL PRACTICE

The Commissioner for Inland Revenue has adopted the Lategan Principle as being the correct interpretation of the term "accrued" as used in the gross income definition, as far as the timing of income recognition is concerned. The departmental practice revolves around the perception that the Lategan Principle consists of two parts, the one being the timing aspect, and the other the valuation aspect. The practice is based upon the "entitled to" interpretation of "accrued", but the income is brought to account at the face value of the accrual, irrespective of when the amount is payable.

The Income Tax Special Court has found that this departmental practice is incorrect in law, and that the Commissioner must take account of the "present worth" of the future instalments (Vorster, 1987). Although there may be two parts to the Lategan principle, they are inextricably linked and cannot be applied separately.

7.3. THE VALUATION OF ACCRUALS

There are enormous, unresolved problems attached to any form of valuation. A valuation is an individual's perception of worth at a particular time. The value of an item may differ from one moment in time to the next,

and the perception of the value may change from valuer to valuer . It is important to recognise that a valuation is essentially only an opinion. No solution to the valuation problems that have plagued accountants and economists for centuries is proposed, but an analysis of the problem may assist in providing some clarification of the situation.

It is essential, first of all, to determine the nature of the asset to be valued. The gross income definition refers to "the total amount, in cash or otherwise". It is evident that there are two classes of assets that have to be included in gross income, viz. cash, and amounts other than in cash.

Cash is defined in the Concise Oxford Dictionary as : "Ready money, actual coins, notes, etc."

It would, however, seem as if the term "cash" has taken on a wider meaning than that attributable to the common usage of the word. Accountants sometimes include bank deposits in their definition of cash. Economists may stretch the definition so as to include certain money market instruments (sometimes also referred to as near-money).

Samuelson (1964) describes cash as follows:
"Cash consists of coins, currency, and money on deposit

in the bank. Cash is the only asset whose value is exact rather than an estimate. All other valuations involve some guesswork, albeit careful guesswork."

Joubert (1976) equates the term "cash" with the term "legal tender". "Legal tender" is defined in the S.A. Mint and Coinage Act (Act 78 of 1964) as being coins and banknotes in South African currency (certain limits are placed on the value of bronze and silver coins, but not on gold coins).

It would seem appropriate to accept the narrow definition of the term "cash", and to limit its meaning to be equivalent to "legal tender". It would seem that even if a wider meaning is attributed to the word, the argument that follows will still be valid.

Murray J found, in the case of Bold v Cooper and another, that: "The mere delivery of a cheque, in a cash transaction, is indisputably not payment of cash.....".

It would appear, also, as if there is a distinct difference in our law between cash and credit sales. (see Sadie v Standard Bank and Laing v South African Milling Co. Ltd.).

The difference between cash and an asset other than cash was well recognised in the Lategan case. Watermeyer J explained:

"So far as a debt was concerned which was payable in the future and not in the year of assessment, it might be difficult to hold that the cash amount of the debt had accrued to the taxpayer in the year of assessment. He had not become entitled to a right to claim payment of the debt in the year of assessment but he had acquired a right to claim payment of the debt in the future. This right had vested in him, had accrued to him in the year of assessment and it was a valuable right which he could turn into money if he wished to do so."

Although Wessels CJ also took cognisance of the difference between cash and a right to claim payment in the Delfos case, it would appear as if the dissenting judgments (delivered by Stratford and de Villiers JJA) ignored this. It does not seem possible that a right to claim payment in the future may become due and payable until such time as the right matures. This would appear to indicate that a right to claim payment in the future should not be considered to be an asset.

The general rule to be followed in the valuation of an asset other than cash received or accrued was established in Lace Proprietary Mines Ltd v CIR (9 SATC

349) as being the amount that could be obtained for it on the open market. This valuation should take place at the time of the accrual (contrary to the proposal in the Lategan case).

A large number of problems may arise:
What if there is no ready market for the asset in question?
What if the asset has value to the recipient, but does not have a value to anyone else, because of its special characteristics?
What if the asset can only be realised at some date in the future?

Probably the most significant problem that arises relates to a taxpayer who sells goods on credit. Presumably, each accrual has to be valued at the time of the sale. The interest rates prevailing at the time of the transaction and the various elements of risk involved will have to be taken into account in determining the present value of the debt, and further, a set of records reflecting these values will have to be kept.

It would seem that if the credit sales were not valued (i.e. some amount deducted from their face values to take account of the time delay between and payment), an inequitable situation wou. where

certain assets other than in cash are valued on one basis, while other assets are valued on a different basis. This is the situation at present, arising from the policy followed by the Commissioner for Inland Revenue.

It is surprising that there has not been a significant move towards the use of promissory notes, bills of exchange and other similar negotiable instruments, rather than credit sales. There may be significant tax benefits attached to the use of negotiable instruments under the present method of valuing accruals of assets other than in cash.

7.4. OTHER PROBLEM AREAS

Consider the position of two taxpayers, A and B, who both enter into an identical transaction. Trading stock is sold to C for an amount of R150, payable at a future date. The future date in question falls outside the current year of assessment. At the time of the sale, the present value of the debt is R100. A waits until the debt becomes due and payable, and collects the R150. B, however, factors the debt with the bank on the same day as the sale, and receives R100 for the debt. B then invests this R100 in a fixed deposit. During the period between the sale and the settlement date B earns interest of R40 on the fixed deposit. This interest of

R40 accrues to B subsequent to the first year end (B only becomes entitled to it at the time that it becomes due and payable, in order to avoid compounding the problem arising from the differences in these concepts).

The transactions described shall be used to demonstrate a number of problems that exist, as far as the accrual of the income is concerned. For the purposes of this study the difference between the present value and the face value of an accrual will be called the "discount".

If the Lategan Principle is followed, it is evident that the rand value of the accrual will differ from the ultimate receipt by the amount of the discount. How should this discount be treated? Is the discount part of the original accrual, and to be ignored? Or should it be taxed as a receipt at the time that the debt is settled?

Case 1. If the discount is ignored, the following position arises:

	Year 1	Year 2
A : Gross income : sale	R 100	-
B : Gross income : sale	R 100	-
: interest	-	R 40

Case 2. If the discount is taxed as a receipt:

		Year 1	Year 2
A : Gross income :	sale	R 100	-
	: discount	-	R 50
B : Gross income :	sale	R 00	-
	: interest	-	R 40

If the "due and payable" interpretation is followed a problem arises in the treatment of B's transactions. It is clear that at the time of the sale B has not accrued anything as no amount is due and payable. When B factors the debt, it would seem appropriate to include the amount received (R100) in gross income (as it is an amount received, not of a capital nature).

Case 3. If the "due and payable" interpretation is followed:

		Year 1	Year 2
A : Gross income :	sale	-	R 150
B : Gross income :	sale	R 100	-
	: interest	-	R 40

It has been assumed in each case, that at the date of settlement of the debt, B has not been entitled to claim payment. The amount became due and payable to, and was received by the factor.

The results may be summarised as follows :

	Year 1	Year 2	Total
A : Case 1	R 100	-	R 100
Case 2	100	R 50	150
Case 3	-	150	150
B : Case 1	100	40	140
Case 2	100	40	140
Case 3	100	40	140

The most striking feature of these results is that in all three cases the result is the same for B, while they differ for A.

In considering the manner in which the Lategan principle was applied in case 2, where the discount was taxed on receipt, the intuitive reaction is to consider the taxation of the value (R100) at the time of the accrual, and the taxation of the discount (R50), at the time of receipt, to be "double taxation" of the discount. This argument could be supported by the fact that the amount of the receipt (the full R150, including the R50 discount) was taken into account in determining the accrual value of R100.

The case for subjecting the discount to tax can apparently be well supported by logically based argument. This argument is based on the fundamental assumption underlying the application of the present value concept. In the valuation exercise the reinvestment of all income at the same rate of return is assumed. The discount earned can thus be compared to the income that would be earned on reinvestment, and should therefore be taxed seperately.

If a comparison is made between A and a money market dealer an interesting observation may result. If the dealer buys a negotiable instrument at a discount and

holds it to maturity, and profits by the amount of the difference between the maturity value and the cost, the net result is that the profit would constitute taxable income. When A holds an asset that increases in value with the effluxion of time (like the negotiable instrument held by the dealer), why should that increase in value not be subjected to tax? If A sold the debt immediately, at the time of the transaction, and reinvested it by means of purchasing another asset that pays the same amount at the same future date, it is clear the A would be treated in the same manner as the dealer, and would be taxed on the discount (profit) of R50. Should the act of interposing a third party in the transaction result in a different position for tax purposes? The fact of the matter is that both A and the dealer would earn income, and that income will actually be paid in the future (i.e. it is not notional in either case).

It is well recognised by economists that the reinvestment assumption in the valuation process is subject to numerous problems. These problems would be compounded if the income in question constitutes a stream of payments (such as a typical suspensive sale arrangement), as opposed to the single payment considered above . The problem regarding the treatment of the discount arises, it is submitted, from the weakness in the assumptions underlying the valuation,

rather than in the tax treatment. The discount is, in fact, part of a single transaction and cannot be treated separately, despite the very convincing arguments to the contrary.

It is interesting to note that in cases 1 and 3, A would be in exactly the same financial position since the present value (i.e. the "real" value) of the resulting tax payments would be exactly the same. Can it be said, then, that although the accruals are treated differently, that there is no effective difference between the Lategan Principle and the "due and payable" interpretation?

7.5. THE COMMISSIONS OF ENQUIRY

The Commission of Enquiry into Fiscal and Monetary Policy in South Africa, referred to as the Franzsen Commission, (paragraph 32, Second Report, RP 86/1970) examined the question of the meaning of "accrued". The Franzsen Commission concluded that the Lategan Principle represents the current law and that no amendment to the Act was necessary.

The Commission of Enquiry into the Tax Structure of the Republic of South Africa, also referred to as the Margo Commission, (paragraphs 9.7 to 9.10, RP 34/1987)

discussed this controversy briefly. This Commission clearly favoured the Lategan Principle over the "due and payable" interpretation.

The Margo Commission discussed the timing of income recognition as follows:

".....While it may be justifiable to defer the gross profit portion of a debt payable in the future, as occurs in the case of a deferral in terms of s 24, the Commission cannot see any justification for deferring the entire amount of the debt until cash is received. After all, inventories are recognised, and they are even further removed from cash. The test of entitlement is clearly appropriate as it determines when an asset exists in the business. In applying the entitlement test, artificial devices which are adopted in an endeavour to defer entitlement must be disregarded. Where a taxpayer has become entitled to a right in terms of which an amount is payable in a future year of assessment, due allowance should be made in the valuation thereof for the futurity of that right beyond twelve months."

The Commission's recommendations are:

"Income should be recognised when all events have occurred which fix the right to receive it and the amount thereof can be determined with reasonable accuracy; but due allowance should be made for the futurity of the right beyond twelve months."

Furthermore, the Commission recommended that there should be some consistency between the test for recognising an accrual of income, and the test for recognising the incurral of expenditure.

A number of observations regarding the Commission's findings are of interest. The Commission could not see any justification for deferring accruals until the cash is received. Possibly the Commission had not come across the "wherewithal to pay" concept described in chapter 4.1. It is submitted that the reason given for not favouring a deferral ("After all, inventories are recognised, and they are even further removed from cash"), is not well founded. The operation of sect 22, in including closing stock in the determinatic of taxable income, does not amount to the recognition o any "income", but is rather the negativing of an "expense". In other words, rather than creating income, section 22 effectively fails to recognise an expense, thus resulting in a mechanism for the deferral of the recognition of expenditure until such time as the associated income is brought to account. If closing stock was valued at market value, including unrealised profits, then the Commission's reasoning might have had some foundation.

The Commission's comment regarding an entitlement "payable in a future year of assessment", and where

some account should be taken in the valuation of the entitlement "for the futurity of that right beyond twelve months", also deserves to be questioned. If the debt is payable in the same tax year that the entitlement arises, but is due after twelve months (in the case of a year of assessment that is longer than a calender year), should some allowance be made for the futurity of the right? Why was the cut-off period of twelve months chosen, rather than, say, nine months, or fifteen months? Possibly a period ending six months after the year end of the taxpayer would be more appropriate, in order to coincide with the timing of the third provisional payment.

It is submitted that the Commission's recommendation that the Act be amended to ensure that all events which fix the right to receive the income must have occurred, and that the amount of the income must be capable of being determined with reasonable accuracy, may have significant impact on the position as it stands at present. The impact would result if this amendment is linked to the recommendation regarding the incurral of expenditure.

It may be argued, however, that the recommended amendment in respect of the recognition of income would, on its own, be superfluous, as the principles in question probably already exist in our law (from, inter

alia, cases such as CIR v Bu.cher Bros (Pty) Ltd, 12 SATC 21 and Mooi v SIR, 34 SATC 1). The present position requires that there be no suspensive condition in existence, and that the income must be quantifiable before it can be included in gross income.

The importance of the Commission's recommendation lies in the linking of the concepts of accrual of income and the incurral of expenditure. The Commission only goes so far as to suggest that the t ming of the accrual of income and the incurral of expenditure should be linked. However, a far greater problem may exist in the inconsistency of the measurement of the quantum of the two items. On one hand a present value exercise is carried out to determine the value of accruals, while on the other no account is taken of the value of expenditure, even though it may be payable in the future.

8. RESEARCH RESULTS

8.1. THE CURRENT LAW

The conflict of ideas regarding the meaning of "accrued to", as used in the gross income definition, has attracted considerable attention over the years. The interpretation that is followed by the courts, at this stage, was initially laid down in the Lategan case. Kriegler J has pointed out that although the Lategan principle has been criticised and doubted, it still constitutes the current law.

In comparing the Lategan principle to the "due and payable" interpretation, no assistance can be found in the Act as to which interpretation should be followed. It is submitted, based upon the discussion in the body of this report, that the current law regarding the accrual of income is as follows:

Income accrues to a taxpayer when he becomes unconditionally entitled to the amount in question. Where the accrual consists of an amount other than in cash (including the right to claim the payment of cash at a future date), the value of the asset must be determined at the time of the accrual.

In applying this interpretation, it is suggested that the following guidelines could be useful in overcoming some of the practical difficulties:

When the income consists of an asset other than cash, the open market value, or an estimate thereof should be used to determine the quantum of the accrual. When the asset accrued is a right to claim future payment, the debt should be valued by deducting an amount from the face value of the debt. The amount deducted from the face value, the discount, should be determined by applying the appropriate interest rate to the face value of the debt for the appropriate period.

The interest rate that is appropriate is the risk-free rate, applicable to the period in question, that is prevailing in the financial market place at the time of the accrual. (The rate attached to gilt edged securities of an equivalent period would seem ideal.) The risk-free rate has been suggested as the risk of default should be accounted for by way of the section 11 (i) and (j) allowances.

The period that should be used in the discounting exercise should start on the date of the entitlement, and should end on the date that the amount becomes due and payable.

8.2. EVALUATION OF THE CURRENT LAW

In order to establish whether the current law, as interpreted in chapter 8.1., possesses the theoretically desirable characteristics described in chapter 4, an evaluation of the law is necessary.

The "wherewithal to pay" principle is not well recognised in the current state of the law. Some relief exists in other sections of the Act (for example sections 24 and 24A) to alleviate the hardship this creates in certain circumstances. The strict adherence to this principle entails the risk of enabling the easy avoidance of the recognition of income by the use of barter-type transactions. It would seem that the principle may be followed without attracting the associated problem by ignoring the principle in recognising the income, but making allowance for the wherewithal to pay at another stage in the determination of taxable income, as is the case in the current law. It is submitted that the current law does not provide adequately for the wherewithal to pay principle, and that greater recognition should be given to this matter.

The realisation concept would appear to be suitably taken into account in the current law (with the exception of the matters detailed above, regarding the

wherewithal to pay principle). The problem that exists in our law, however, is that the realisation concept is not spelled out clearly in the legislation, but results mainly from case law and current business and accounting practice. In other countries, most notably the United States, extensive use is made of detailed sets of rules and the publication of the practice followed by the revenue authorities. It may be appropriate to formulate a set of rules to be followed if the realisation concept is to be amended in any way. As is the case with the wherewithal to pay principle it would seem as if the realisation concept should be recognised in the calculation of taxable income at some stage after the determination of gross income.

The concepts of equity and uniformity are adequately represented in the interpretation detailed in chapter 8.1. These principles are neglected in the commonly held interpretation whereby unpaid debts accrued during the tax year are valued at the year end as there is a divergence between the valuations of different types of accruals that consist of non-cash assets.

Ease and consistency of administration, it is submitted, cannot be achieved under the current law. The fact that valuations are virtually always based on subjective criteria must surely result in inconsistency in the valuation of non-cash accruals. Furthermore, the

diminishing use of cash in the economy, with greater use of credit sales and negotiable instruments, the number of non-cash accruals that require valuation would, in many (if not most) businesses, necessitate an administrative burden of immense proportions. Although no empirical evidence has been sought to substantiate this contention, it is submitted that the current law (as interpreted in chapter 8.1.) cannot operate in a modern economy where the vast majority of transactions are not cash transactions. It would seem as if this matter requires the attention of the legislature.

The social and economic objectives that are considered desirable may be dealt with adequately in the determination of taxable income without interfering with the accrual of gross income. The manner in which these objectives are achieved in the present law, with certain types of income being exempt, appears to be the best method of achieving the desired result. (Whether the result is desirable is a question that warrants investigation.)

8.3. OTHER FINDINGS

The controversy that has arisen over the interpretation of "accrued to" may be of limited relevance as there may be no effective difference between the two concepts. If the Lategan principle is applied correctly (contrary to current Departmental practice) the income in question should be quantified in such a manner that it has the same economic value as the quantum of income that would be brought to account under the "due and payable" interpretation. Although there may be a difference in the timing of the income recognition, there would be no economic difference.

There are many, varied factors to take into consideration when devising a method of recognising income for tax purposes. The complexities of the issues involved require that any changes to the existing law or the development of an entirely new income recognition method should be very carefully researched and tested before any attempt is made to put them into place. The recommendations formulated by the Margo Commission appear, on the surface, to be entirely reasonable and appropriate. However, on closer scrutiny it is evident that these recommendations are far from being suitable.

Other methods of recognising income that have been examined in this report, specifically the methods used in other tax jurisdictions and by accountants, have proven to be workable over a number of years. There is no doubt that on closer examination these other methods may be shown to have flaws. However, the relevant point is that they are workable, whereas the current law, as interpreted in chapter 8.1, it is submitted, is not capable of being applied in practice.

It appears as if the main problem faced in the application of the current law is the manner in which accruals are valued. The valuation exercise has certain inherent problems and may be incompatible with the purpose for which it is being used. Accountants have faced a similar problem in attempting to combine economic valuations with historic cost accounting in what is called Current Cost Accounting (CCA). At one time there was considerable support for CCA among the accounting fraternity, but this has waned somewhat over the past decade. It was found that the incompatibility of the concepts involved in CCA provided results that were of limited use.

The valuation of accruals, specifically in respect of debts, leads to the problem of how the discount (the difference between the face value and the present value of the debt) should be treated. It is not at all clear

what route should be followed in this regard, as the alternative courses of action may each be justified by logical argument. It is important to note that none of the foreign jurisdictions examined use valuations in determining the quantum of the accrual of debts. The face value of the debt is taken into account at the date of entitlement.

9. CONCLUSIONS

It is predicted that the South African revenue authorities will be forced to abandon their long-standing policy regarding the accrual of income (whereby the valuation aspect of the Lategan Principle is ignored) in the near future. Although this policy is far from being perfect, it has one redeeming feature in that it works. The revenue authorities have been able to achieve a good level of ease and consistency in administration, especially in dealing with credit transactions, through the use of this policy. At long last a taxpayer has taken Revenue to task on this matter (see Vorster, 1987) and it appears as if the time has come for amendments to the legislation, as Revenue will probably be unable to administer effectively the existing law without the use of their present Departmental Practice.

If and when the gross income definition is amended, it is recommended that the four concepts described in chapters 4.1. to 4.4. should be kept firmly in view. The artificial nature of determining income adopted by the Act enables the relatively easy implementation of these concepts. It is suggested that the recognition of "gross income " can be kept fairly simple, while the adoption of the important concepts can be incorporated

at a later stage in the determination of taxable income. Changes to the method of recognising income will necessitate a process of re-education of the people involved in the practice and administration of tax matters and it is submitted that at this stage it may be appropriate to maintain the same basic format as exists at present. Furthermore, the artificial nature of the income determination process provides the opportunity to create a mechanism whereby any valuation exercise that may be required can be removed from the recognition stage in order enable some control over the valuation exercise.

In the formulation of any potential solution to the problems examined in this paper it is suggested that there is much to be learned from the experience of others. From a practical point of view, the Revenue has always relied upon the accountants to provide the basis for the preparation of returns of income. Although there are significant differences between accounting and taxable income, reliance has always been placed on accounts drawn up from historic costs and undiscounted receivables and payables. Should the Commissioner wish to discard the traditional method of keeping accounts and move towards a present value recognition of transactions, he would have to keep his own score or formulate a method of converting historic cost financial statements appropriately.

The gross income definition is the cornerstone of the Act, and its importance cannot be underestimated. The time for amendments to either the Act or the Departmental Practice is almost upon us. In order to avoid hasty and inappropriate action being taken by the revenue authorities, the necessary research should be undertaken as soon as possible so as to formulate suitable solutions to the problems that have been identified in this research report.

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